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Nos. 75-1221, 75-1260 and 75-1285

In the Supreme Court of the United States

OCTOBER TERM, 1976

UNITED STATES OF AMERICA, PETITIONER

v.

CONSUMER LIFE INSURANCE COMPANY

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, PETITIONER

v.

UNITED STATES OF AMERICA

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS AND THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. The central point of our submission in these cases, as set forth in our opening brief (pp. 37–41), is that

the term "unearned premiums" in Section 801(c)(2) (26 U.S.C.) refers to the unearned premium *reserve* that reflects an insurance company's liability to meet casualty insurance claims. Under the two types of reinsurance arrangements at issue, the taxpayer companies bore the risk of meeting claims with respect to the accident and health coverage.[1] Thus, the accident and health unearned premium reserves attributable to such coverage must be included in their "total reserves" under the statute, despite the temporary physical possession of the unearned premium dollars by other insurance companies which were parties to the arrangements.

[1] Respondent Penn Security (No. 75–1285) does not appear to challenge the fact that it assumed the accident and health insurance risks under the Treaty I-type arrangements involved in that case (see Br. 36–39). However, with respect to the same type of reinsurance treaty, Consumer Life (No. 75–1221) contends (Br. 4–5): (1) that it did not concede that it assumed the insurance risk; and (2) that the Court of Claims did not find that it had made such a concession. But the record shows that Consumer Life's counsel stated at trial that "ultimately way on out many, many months or years, 100 percent of the risk would be borne by Consumers. There's no question about that" (No. 75–1221—A. 131.) The Court of Claims therefore properly found that "[u]nder Treaty I, all life and A & H policies * * * were to be fully reinsured with plaintiff [Consumer Life] which, as it freely concedes, thereby assumed the entire insurance risk represented by each of the policies involved" (No. 75–1221—Pet. App. B 70a).

Petitioner First Railroad (No. 75–1260) similarly denies (Br. 9–10) that its expert witness conceded that the Treaty II-type arrangement did not shift the insurance risk to the other company. But an examination of his testimony shows that he refused to state that the arrangement spread the risk of the loss except in the limited sense that the arrangement permitted the company to take on more business (see No. 75–1260—A. 123).

In response, the taxpayers have advanced contradictory, but equally unsound, arguments as to the meaning of the statutory term "unearned premiums" and the nature of an insurance reserve.

a. *No. 75–1221.* Respondent Consumer Life Insurance Company acknowledges the correctness of our statutory analysis that the term "unearned premiums" refers to the unearned premium reserve that represents a company's liability to meet claims. Nevertheless, it contends (Br. 20–21) that as a matter of state law and accounting practice, it was not required to establish a liability for an unearned premium reserve because it had no corresponding "unearned premium" asset. However, the language and structure of Section 801(c) demonstrate that state law requirements have no relevance in determining whether "unearned premiums" are includable in a company's total reserves under Section 801(c)(2).

Section 801(c) lists three types of reserves: "(1) life insurance reserves, (2) unearned premiums, and unpaid losses * * * not included in life insurance reserves, and (3) all other insurance reserves required by law." As in the case of the third category of "all other insurance reserves", the Code prescribes that the first category—"life insurance reserves"—must also be "required by law" in order to be taken into account for federal tax purposes. See Section 801(b)(2); Treasury Regulations, Section 1.801–4(a)(3) (26 C.F.R.). Section 1.801–5(b) further defines the phrase "required by law" as state statutory or regulatory law.

However, in marked contrast to the first and third categories of reserves set forth in Section 801(c), the statute does not employ the term "required by law" with respect to the second category of reserve—"unearned premiums." Congress therefore intended that the question of inclusion in "total reserves" of "unearned premiums"—the special type of reserve applicable only to casualty insurance—was to be determined without regard to state law. Indeed, in defining the term "unearned premiums," Treasury Regulations, Section 1.801–3(e) expressly provides that "[s]uch term includes all unearned premiums, *whether or not required by law*" (emphasis supplied). Thus, the only relevance of state law for purposes of Section 801(c)(2) is to confirm the proposition that the unearned premiums reserve for nonlife coverage must be attributed to the company that bears the insurance risk (see our opening brief, pp. 66–75).[2]

[2] As we demonstrate in our opening brief (pp. 66–75), the state statutes to which the taxpayers were subject required them to establish unearned premiums reserves for the accident and health coverage on which they assumed the risk. However, all three taxpayers argue that the state officials' failure to require them to establish such a reserve and those officials' acquiescence in the establishment of the reserve by the other companies show that the accident and health reserve was not a reserve "required by law" within the meaning of Section 801(c)(3) (see Consumer Life, Br. 25; First Railroad Br. 30–34; Penn Security Br. 31–36). In support of this contention, Penn Security cites (Br. 33) Treasury Regulations, Section 1.801–5(b). That Regulation provides that one of the elements of the term "required by law" is that the reserve be "reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries."

But this Regulation only comes into play with respect to the third catch-all category of reserves under Section 801(c)(3)—"all other insurance reserves required by law." Thus, if, as we submit, the reserves in question are "unearned premiums" under Section 801(c)(2), the state officials' acceptance of the taxpayers' annual statements has no relevance. At all events, the history of Section 1.801–5(b) of the Regulation establishes that the quoted phrase was intended to permit insurance companies to compute "other" types of reserves on a more conservative basis than the minimum amounts required by the state reserve valuation statutes. The proposed regulations would have prescribed the minimum statutory valuation reserves as "required by law" (see 25 Fed. Reg. 7983, 7986). However, we are advised by the Department of the Treasury that it modified the Regulation to permit companies to compute their reserves on a more conservative basis after the insurance industry argued that the term "required by law" referred only to the type and not the amount of the reserve. Cf. *Lamana-Panno-Fallo I. Ins. Co.* v. *Commissioner*, 127 F. 2d 56, 58 (C.A. 5). Hence, the computational question addressed by the Regulation has no bearing on the reserve attribution issue presented in these cases.

[3] Respondent Penn Security relies (Br. 33) upon *State ex rel. American Central Ins. Co.* v. *Gehner*, 320 Mo. 901, 9 S.W. 2d 621, as authority for the proposition that it was not required by Mis-

At all events, as we have discussed in greater detail in our opening brief (pp. 69–72), there is no matching principle under the state statutes to which the taxpayers were subject in these cases that a reserve can only be established if there is a corresponding asset. To the contrary, state law contemplates the establishment of an unearned premium reserve upon assumption of the insurance risk even prior to the time that the right to receive the premiums becomes fixed.[3]

Finally, even assuming *arguendo* the existence of such a matching principle, the generally accepted accounting treatment of reinsurance, endorsed by a leading reinsurance text (Hammond, *Insurance Accounting Fire & Casualty* (2d ed. 1965)), requires the creation of a corresponding asset. Professor Hammond states that even if the issuing company in a reinsurance transaction such as the Treaty I-type arrangement withholds payment of the account under the provisions of the agreement "for an extended period," the accounting treatment on the reinsurer's books "is the same as any other premium transaction, except that the *Funds Held By or Deposited With Ceding Reinsurers* account is debited instead of *Agents' Balances or Uncollected Premiums* or *Cash.*" *Id.* at 142.[4]

souri law to establish a reserve for the accident and health coverage. But that state tax case deals with reserves with respect to uncollected premiums, which are in no way comparable to the premiums that were paid in advance by the policyholders and temporarily held by another company on behalf of Penn Security.

[4] Professor Hammond further states (p. 143) that "[w]hen the funds are withheld over an extended period, the contract may provide for the payment of interest on the money." Thus, the receipt of interest income is simply one of many elements of the economic arrangement between the ceding company and the reinsurer and should not control the question of attribution of the reserves for federal tax purposes. For example, a depositor's ownership of the funds in his checking account is hardly diminished by the fact that the account is non-interest bearing.

There is accordingly no basis to Consumer Life's (No. 75–1221—Br. 30) and Penn Security's proposed distinction (No. 75–1285—Br. 14) of their cases from *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (C.A. 7), certiorari denied, 420 U.S. 947, rehearing denied, 421 U.S. 922, motion for leave to file a second and untimely petition for rehearing pending, No. 74–701, on the ground

Thus, the reinsurer is deemed to have received the premiums at the very outset of the arrangement and the ceding company's temporary physical possession of the premiums is ignored.[5]

that in *Economy Finance* the taxpayer received the interest income from the unearned premiums. Indeed, the Seventh Circuit in *Economy Finance* mentioned the interest income point in passing (see *id.* at 480) and properly declined to give it great weight.

Finally, the excerpt from Thompson, *Reinsurance*, p. 174 (4th ed. 1966), quoted by Penn Security (Br. 35, n. 15), does not contradict Professor Hammond's analysis. The statement in Thompson is made in the context of describing a special form of reinsurance known as excess loss reinsurance. Under excess loss reinsurance, the reinsurer assumes the risk of losses beyond a stated portion of gross premiums rather than a quota share of all losses. Thus, in such an arrangement, the ceding company continues to retain the reserve for unearned premiums because it remains liable on the risk represented by those premiums (see our opening brief, pp. 74–75, n. 30). Under excess loss reinsurance, the reinsurer may also establish a reserve based upon the premiums for the excess reinsured risk. Here, however, in the Treaty I-type arrangement, the taxpayers must establish a reserve equal to the gross unearned premiums because they assumed the entire risk under the policies.

[5] Consumer Life further argues (Br. 36, n. 12) that its Treaty II-type arrangement qualifies as a "sliding scale" agreement recognized by National Association of Insurance Commissioners, *Examiners Handbook*, pp. B16–B17 (1970 ed.) (see No. 75–1260—A. 235–236). But a "sliding scale" agreement, as described in the *Handbook*, is one that provides for a sharing of the profits of a favorable loss experience by means of a pro rata return of reinsurance premiums to the ceding company. Here, however, the reinsurer simply had a three percent stake in the premiums and did not share in either the losses or the profits.

Consumer Life (Br. 35) and First Railroad (Br. 11, 33) also argue that its Treaty II-type arrangements were not "surplus aid" agreements, as that term is described in the *Examiners Handbook*, pp. B14–B16 (No. 75–1260—A. 230–235). But the critical fact is not that the Treaty II-type arrangements served to aid the tax-

b. *No. 75–1260.* Petitioner First Railroad & Banking Company of Georgia adopts an opposite position. It urges (Br. 34–38) that the term "unearned premiums" in Section 801(c)(2) does not mean the unearned premium reserve but refers to the actual premium dollars. Thus, First Railroad claims that it had no "unearned premiums" because it temporarily relinquished those premium dollars to another company. In support of this argument, First Railroad relies upon Treasury Regulations, Section 1.801–3(e), which defines "unearned premiums" as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance." In its view (Br. 36), the word "amounts" in the Regulations refers to the actual premium dollars.

But as we have pointed out in our opening brief (pp. 37–41), the phrase "unearned premiums" is the accepted insurance industry terminology for the unearned premium reserve, which traditionally represents the measure of the liability of a company to meet claims for short-term casualty coverage. See Hammond, *supra,* at p. 177. Since Section 801(c) deals with the single subject of insurance reserves, the term "unearned premiums" necessarily refers to the unearned premium reserve and not the premium dollars by which that reserve is measured.

Moreover, there is no basis to First Railroad's con-

payers' surplus in a particular manner but that there was no shifting of the risk to the other companies—"[t]he essential element of every true reinsurance contract." *Examiners Handbook*, p. B6 (No. 75–1260—A. 211).

tention that the word "amounts" in Section 1.801–3(e) of the Regulations refers to the actual premium dollars rather than to the amount of the unearned premium reserve. While the measuring rod of the unearned premium reserve is the unearned premiums, the unearned premiums are not conceptually equivalent to the reserve, which represents the company's liability to meet claims. Thus, the Regulation simply prescribes the method of computing the unearned premium reserve. Indeed, the word "amounts" cannot be read in isolation but must be considered in the context of the entire phrase which immediately follows, *viz.,* "amounts which shall cover the cost of carrying the insurance risk * * *." Since the taxpayers bore the insurance risk under each of the arrangements at issue, the "amounts" put to that risk are properly includable in their total reserves.[6]

[6] Respondent Penn Security (No. 75–1285) also relies upon Section 1.801–3(e) of the Regulations (Br. 24–27). However, it seizes on the term "paid in advance" and argues that it is not chargeable with the accident and health insurance reserves because it did not receive premiums "paid in advance" within the meaning of the Regulation.

To be sure, as Penn Security suggests (Br. 47), there can be no unearned premium reserve without premiums "paid in advance." But the Regulation does not provide that only the company receiving non-life premiums "paid in advance" must include the amount of such premiums in its earned premium reserve. If, as here, the company receiving such advance premiums reinsures the risk with another company, it is the reinsurer that bears "the cost of carrying the insurance risk for the period for which the premiums have been paid in advance" within the meaning of the Regulation. Here, it is undisputed that the taxpayer companies assumed the risk for the entire period of coverage for which the policyholders paid advance premiums (see also our opening brief, p. 59, n. 18).

c. *No. 75–1285.* Finally, respondent Penn Security Life Insurance Company argues (Br. 27–30) that the accident and health insurance reserves cannot be included in its "total reserves" because an insurance reserve is an actual sum of money and it did not "actually hold" such a fund within the meaning of Treasury Regulations, Section 1.801–5(a)(3). While insurance reserves have been sometimes described in a colloquial manner as funds set aside by the company, the authoritative insurance texts reject the characterization of reserves as assets; to the contrary, they define them as liabilities of the company to the policyholders. Thus, as stated in Dickerson, *Health Insurance,* pp. 526, 528 (Rev. ed. 1963): "Reserves are balance sheet accounts set up to reflect actual and potential liabilities under outstanding insurance contracts" and "Premium reserves represent liabilities for events which have not yet taken place." Similarly, Professor Hammond describes unearned premiums as "distinctive insurance company liabilities" and "*non ledger liabilities,* [which] are of major importance in establishing total liabilities * * *." Hammond, *supra,* at pp. 148, 177 (emphasis in original).[7] Accord: Mertens, *Law of Federal Income*

[7] See also Greider and Beadles, *Principles of Life Insurance*, pp. 68–69 (Rev. ed. 1972). While that text deals specifically with life insurance, the following description of reserve in that text is appropriate to all types of insurance reserves:

"It is doubtful that any other single life insurance concept lends itself more readily to misunderstanding than the idea of the policy reserve. The word 'reserve' is not to well chosen because it is used in several different ways in accounting and finance, where it may mean an asset, a reduction from an asset, or a liability. In life insurance, the policy reserves (the legal reserves) are liabilities. They are established as a way of determining or measuring the assets the company must maintain in order to be able to meet its future commitments under the policies it has issued.

The level-premium system contemplates the investment of that part of every net premium which exceeds the current cost of protection. It is frequently said that these amounts are 'held' and invested, to be used in the payment of claims in later years. However these amounts are not really held or invested as a separate fund and, indeed, the 'reserve' itself is not a fund—that is, it is not money, not assets of any kind. Thus, the reserve cannot be 'invested,' and it is not 'used' in later years when current premiums received by the company are not sufficient to meet current claims."

Taxation, § 44.26, n. 1 (1970 ed.), quoted at pp. 18–19 of Brief for Consumer Life.

Once it is understood that an insurance reserve is a liability and not a particular sum of money, it becomes readily apparent that the accident and health reserves were properly includable in the taxpayers' "total reserves" because they represent the liability of meeting claims of the policyholders. Since an insurance company does not physically set aside particular funds for reserves, the statement in Section 1.801–5(a)(3) of the Regulations that "the reserve must have been actually held during the taxable year for which the reserve is claimed" simply means that the company must in fact bear the liability with respect to insurance during the year for which it claims a reserve.[8]

[8] The correlation between an insurance reserve and the liability for the insurance risk is further shown by Treasury Regulations, Section 1.801–4(a)(3). While that Regulation also uses the word "held" in connection with life insurance, it states that "reserves held by the company with respect to the net value of risks reinsured in other solvent companies * * * shall be deducted from

2. Respondent Penn Security further argues (Br. 39–41) that the reinsurance arrangements in these cases are "substantially similar" to "modified coinsurance," as that term is defined by Section 820(b) of the Code. In its view, the treatment accorded to modified coinsurance by Section 820 is inconsistent with any congressional intention to attribute insurance reserves to the company that bears the risk.

But Section 820(b)(1) makes clear that the tax rules governing modified coinsurance are applicable only to life insurance and not to the short-term casualty coverage involved in these cases. Unlike reserves for short-term casualty insurance which are computed solely on the basis of the current actuarial risk in the form of a pro rata unearned premium, ordinary life insurance reserves are computed with an additional investment element. In the typical long-term premium life or noncancellable health insurance contract, the annual premiums received at the outset will exceed the cost of the insurance, but will be less than the cost of the insurance at the end of the term. Thus, there is an additional element in life insurance reserves that is computed on the assumption that the company will invest the excess of premiums over the cost of insurance at an assumed rate of interest in order to meet the obligation to pay bene-

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the company's life insurance reserves." The transfer of the risk through reinsurance need not occasion the physical transfer of specific "reserve funds," but simply requires the ceding company to reduce its reserve liabilities and the reinsurer to increase its reserve liabilities.

fits at the end of the term when the annual premiums are less than the cost of the insurance. See McLean, *Life Insurance,* pp. 111–114 (9th ed. 1962); *Massachusetts Protective Assn.* v. *United States,* 114 F. 2d 304, 308–209 (C.A. 1). Since it is this investment element that generally constitutes the bulk of life insurance reserves, it is the location of the corresponding assets held for investment by the insurance companies that determines which life insurer is chargeable with the life insurance reserve liability.

As the legislative history of Section 820 points out, modified coinsurance is a special form of life reinsurance where the reinsurer accepts the risk but the initial insurer retains the reserves and administers the investment of the assets corresponding to the reserves. However, the initial insurer pays over the gross investment income, less additions to reserves, to the reinsurer. The reinsurer, in turn, is obligated for all expenses incident to the coverage. See McGill, *Life Insurance,* pp. 438–440 (Rev. ed. 1967); Steffer, "Life and Health Reinsurance" in Gregg, *Life and Health Insurance Handbook,* p. 1037 (2d ed. 1964).

In these cases, Congress was concerned that the investment income might be taxed twice—once to the initial insurer as investment income, and again to the reinsurer as underwriting gain. In order to avoid that possibility, Section 820 permits the parties to such a reinsurance agreement to elect to treat the arrangement for tax purposes as if the reinsurer had issued the policy directly—as in a regular "coinsurance" transaction. Once the election is made, the re-

insurer is deemed to have received the premiums, incurred the expenses, and maintained the reserves with respect to the coverage.[9] See Section 820(c); S. Rep. No. 291, 86th Cong., 1st Sess., pp. 38–39 (1959).

It is therefore plain that the special life insurance reserve considerations that prompted Congress to enact Section 820 cannot be extrapolated into a generalized assertion of legislative intent with respect to the question of attribution of casualty insurance reserves in these cases. Unlike the situation addressed by that statutory solution with respect to modified coinsurance, reserves for the short-term cancellable [10]

[9] In the absence of such an election, the initial insurer is deemed to maintain the reserve. See Rev. Rul. 70–508, 1970–2 Cum. Bull. 136.

[10] Penn Security argues (Br. 45, n. 24) that the accident and health policies were "noncancellable life, health or accident policies" which would be eligible for inclusion in both the numerator and the denominator under the 50 percent test of Section 801(a)(2). Because the Court of Claims held that the "unearned premiums" were not includable in Penn Security's "total reserves" under Section 801(c), it did not reach this additional contention. If the government prevails in the reserve attribution question before this Court, the case should be remanded to the Court of Claims to consider Penn Security's claim that the policies were noncancellable.

At all events, the legislative history of the predecessor of Section 801(a) clearly establishes that a "noncancellable" insurance policy is one which the company must renew at a specified premium and with respect to which a reserve (in addition to the pro rata unearned premium) must be established to cover the renewal obligation. See H.R. Rep. No. 2333, 77th Cong., 2d Sess., p. 109 (1942); see also Treasury Regulations, Sections 1.801–3(c) and 1.801–3(d). This additional reserve corresponds to the element in life insurance reserves calculated upon the assumption of the investment at interest of the level premium in excess of the current cost of insurance. See *Massachusetts Protective Assn.* v. *United States*, *supra*. Here, Penn Security did not give its policyholders a right to renew and did not maintain a renewal reserve. In the absence of such a reserve, the courts of appeals have uniformly held that such policies are not "noncancellable." See *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945, 951 (C.A. 4); *Group Life and Health Insurance Co.* v. *United States*, 434 F.2d 115 (C.A. 5), certiorari denied, 402 U.S. 944; *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 480–482; *United Benefit Life Insurance Co.* v. *McCrory*, 414 F.2d 928 (C.A. 8), certiorari denied, 396 U.S. 1039.

coverage here are based only on the pro rata unearned premium and do not contain any element computed on the assumption of the company's investment of corresponding assets at a stated rate of interest. Since there are no investment assets corresponding to the short-term casualty insurance reserves involved here, these cases are not analogous to a modified coinsurance arrangement for life insurance contracts in the absence of an election under Section 820.[11]

3. Finally, First Railroad argues (Br. 16–19, 43–50) that the court of appeals improperly reversed the

[11] Penn Security further argues (Br. 42–45) that if the Court agrees with our submission that its accident and health reserves are included in its "total reserves," they should be included only on a net basis exclusive of loading costs. As in the case of Penn Security's argument that the policies were "noncancellable" (see n. 10, *supra*), the Court of Claims did not reach this contention. However, the appellate cases have thus far uniformly rejected Penn Security's position. See *Superior Life Insurance Co.* v. *United States*, *supra*, 462 F.2d at 951; *Economy Finance Corp.* v. *United States*, *supra*, 501 F.2d at 482–483. Moreover, Penn Security's expert witness testified that the general practice is to establish such reserves on a gross basis (see No. 75–1285—A. 203, 222–223). Accord: National Association of Insurance Commissioners, *Examiners Handbook*, p. B13 (1970 ed.) (No. 75—1260–A. 228).

district court's decision in its favor because the "clearly erroneous" standard of Fed. R. Civ. P., Rule 52(a) protected the district court's finding that "there were substantial non-tax purposes for entering into the [Treaty II-type] arrangement" (No. 75–1260—Pet. App. B 14a). In the district court's view, the arrangement permitted Georgia Life to reduce its ratio of net written premiums to surplus so as to permit it to increase the volume of its credit accident and health business (No. 75–1260—Pet. App. B 14–15a).

But the court of appeals did not dispute the district court's finding in this respect. It was therefore not bound by the "clearly erroneous" rule of Rule 52(a). Rather, the court of appeals concluded, as a matter of law, that the proper test to be applied in determining whether the arrangement was reinsurance termed on whether or not there was a shift of the insurance risk on the underlying policies to Georgia Insurance. Since Georgia Insurance "did not bear any risks except the outside possibility of insolvency of [Georgia Life]," the court of appeals properly held that "there was no substance to the agreement as reinsurance" (Pet. App. A 4a–5a). Indeed, the decision of the court of appeals is buttressed by the district court's acknowledgement that "the risk of loss upon Georgia Insurance was, in actuality, remote" (Pet. App. B 14a).[12]

[12] The only risk Georgia Insurance actually assumed under the agreement was that claims on the ceded coverage would exceed 96 percent of the premiums, a figure more than four times the average claims experience. Indeed, even in that unlikely event, Georgia Insurance could recover such excess losses out of future premiums (Pet. App. B 14a).

CONCLUSION

For the reasons stated above and in our opening brief, the judgments of the Court of Claims in Nos. 75–1221 (*Consumer Life*) and 75–1285 (*Penn Security*) should be reversed, and the judgment of the court of appeals in No. 75–1260 (*First Railroad*) should be affirmed.

Respectfully submitted.

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